Supreme Court, U. S.
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IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1977

No. 77-1824

M. SETH HORNE and MAURINE D. HORNE,

Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE

Appellee.

PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

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The petitioners, M. SETH HORNE and MAURINE D. HORNE, respectively pray that a Writ of Certiorari be issued to review the judgment herein of the United States Court of Appeals for the Ninth Circuit (hereinafter referred to as the Ninth Circuit) entered in the above-entitled case on September 30, 1975, petition for rehearing denied on March 27, 1978.

OPINIONS, JUDGMENTS, AND ORDERS BELOW

On November 27, 1972, the United

States Tax Court (hereinafter referred to as the Tax Court) filed its opinion herein which is reported at 59 T.C. 319 (1972) and pursuant thereto entered its decision on February 12, 1973. The opinion and decision are set forth in the appendix at pages 1 through 40 and at page 41, respectively.

The Ninth Circuit filed its opinion and judgment on September 30, 1975, affirming the decision of the Tax Court. The opinion is reported at 523 F.2d 1363 (9th Cir., 1975) and set forth in the appendix at pages 42 through 49.

On March 27, 1978, the Ninth Circuit filed its order denying petitioners' petition for rehearing. The order is set forth in the appendix at page 50.

JURISDICTION

The judgment of the Ninth Circuit was filed on September 30, 1975, and the order denying the petition for rehearing was filed on March 27, 1978. Jurisdiction of this Court is invoked under 28 U.S.C. Section 1254 (1).

QUESTION PRESENTED

Where the taxpayer, M. SETH HORNE, made payments pursuant to an indemnity agreement, entered into by him with a bonding company concerning an antecedent debt for which he had no responsibility, are such payments deductible either as ordinary and necessary business expenses under Section 162 or losses incurred in a trade or business, or incurred in a transaction entered into for profit under Section 165(c) of the

Internal Revenue Code of 1954?

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1954:

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) In General.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business,
. . .

(26 U.S.C.A. § 162)

SEC. 165. LOSSES.

(a) General Rule.--There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(c) Limitation on losses of individuals.--In the case of an individual, the deduction under subsection (a) shall be limited to

(1) losses incurred in a trade or business;
(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business;

(26 U.S.C.A. § 165)

SEC. 166. BAD DEBTS.

(a) General Rule.--

(1) Wholly worthless debts.--There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

.....

(d) Nonbusiness Debts.--

(1) General rule.--In the case of a taxpayer other than a corporation--

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and . . . .

(2) Nonbusiness debt defined.--For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than--

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

(26 U.S.C.A. § 166)

Treasury Regulations:

REG. § 1.166-5

* * *

(b) Nonbusiness debt defined--For purposes of section 166 and this section, a nonbusiness debt is any debt other than--

(1) A debt which is created, or acquired, in the course of a trade or business of the taxpayer, determined without regard to the relationship of the debt to a trade or business of the taxpayer at the time when the debt becomes worthless; or

(2) A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

The question whether a debt is a nonbusiness debt is a question of fact in each particular case. The determination of whether the loss on a debt's becoming worthless has been incurred in a trade or business of the taxpayer shall, for this purpose, be made in substantially the same manner for determining whether a loss has been incurred in a trade or business for purposes of section 165(c)(1). For purposes of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception provided by that subparagraph. * * *

Treas. Reg. § 1.166-5, T.D. 6500, 26 C.F.R. § 1.166-5 (1960)

REG. § 1.166-1(c)

Only a bona fide debt qualifies for purposes of section 166. A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. A gift or contribution to capital shall not be considered a debt for purposes of section 166.

Treas. Reg. § 1.166-1(c), T.D. 6996, 26 C.F.R. § 1.66-1(c) (1970).

STATEMENT OF THE CASE

The taxpayers, M. SETH HORNE and MAURINE D. HORNE, are husband and wife and reside in Phoenix, Arizona. M. SETH HORNE (hereafter referred to as "HORNE") is a real estate developer and investor. In 1951, HORNE and two others formed a general partnership (hereafter the "Partnership") to engage in the business of real estate development. Later that year, the Partnership purchased all the outstanding shares of James Stewart and Co., Inc. (hereafter referred to as "COINC"), thinking that COINC's construction activities would compliment the Partnership's real estate activities. The total purchase price amounted to $296,406.25. COINC's stock was acquired in the names of the individual partners according to their interests in the Partnership. HORNE's basis in the COINC stock was $194,442.50. At that time, COINC had a wholly owned subsidiary, James Stewart Corporation

(hereafter referred to as "CORP"). In 1952, COINC caused a second subsidiary, James Stewart Company (hereafter referred to as "CO") to be formed. Like COINC, both CO and CORP performed construction and general contracting work.

In the conduct of their construction business, the three corporations were required to post performance bonds on the jobs they undertook. Bonds were obtained from the New Amsterdam Casualty Company (hereafter referred to as "NEW AMSTERDAM"). COINC and CORP agreed to indemnify NEW AMSTERDAM for any losses incurred as surety for CO. CORP and CO agreed to in demnify NEW AMSTERDAM from any losses incurred surety for COINC.

From the start, HORNE and the other partners were active in the management of COINC as members of its board of directors. HORNE was immediately made Vice-President. He held that office until 1955, when he was elevated to President and Chairman of the Board -- positions which he held through 1960. HORNE was also a member of the board of directors of both CORP and CO. In 1953, HORNE was elected Vice-President of CORP, and in 1954, chairman of its board. HORNE was president of CO from its inception.

The Partnership was the manager of COINC, and CORP and CO were its operational arms. The Partnership engaged in all phases of real estate development,

although after acquiring COINC, a great deal of the partners' time was devoted to overseeing the parent and its subsidiaries.

During the years 1952 through 1960, HORNE received no compensation of any kind from COINC, CORP or CO for services rendered. Also, none of the corporations paid any dividends during those years. CORP and CO did, however, pay management fees to COINC; and COINC in turn paid management fees to the Partnership.

By 1960, all three corporations were in severe financial trouble. NEW AMSTERDAM was informed that CO could not complete all its contracts and that COINC and CORP did not have sufficient funds to meet their obligations as indemnitors under the cross-indemnity agreements. At this point, NEW AMSTERDAM estimated its liability on the bonds written on CO's behalf at approximately one and one-half million. None of the partners were individually liable on the bonds and therefore NEW AMSTERDAM requested the partners to contract to indemnify it for any loss incurred on the three corporations' bonds. The other partners refused, but HORNE acceded. He did so realizing that unless he agreed, the corporations would be taken over by the bonding company, their assets would be liquidated and they would probably end up in bankruptcy. Not only would he lose his investment in COINC, but, most importantly, his

credit reputation would be ruined. Thus, because the ability to borrow large amounts of money was crucial to the conduct of a real estate development business, HORNE would no longer be able to participate in such business on an individual basis, or as a major figure in a partnership or corporation.

In January 1961, following negotiations, HORNE and NEW AMSTERDAM entered into an indemnity agreement whereby HORNE and CO jointly and severally agreed to pay NEW AMSTERDAM amounts expended by NEW AMSTERDAM pursuant to bonds issued in connection with the contracts previously entered into by CO, and all amounts for which CO was obligated under the earlier cross-indemnity agreements. The agreement between NEW AMSTERDAM and HORNE was unlike usual indemnity agreements entered into by a bonding company and a third-party indemnitor. Generally, a bonding company requires the indemnity agreement at the outset of the transaction and the indemnification is given at the time the bond application is executed. The agreement between NEW AMSTERDAM and HORNE was an original undertaking by him.

Contemporaneous with the negotiation of the January 20 agreement, the Partnership was dissolved and the corporations reorganized with HORNE receiving all the stock in CO.

In accordance with the January 20 agreement, HORNE paid to NEW AMSTERDAM $237,434.46 in 1966, $121.749.22 in 1967, and $238,246.66 in 1968.

He deducted one-half of these amounts as losses. The balance for each year was treated as a loan to CO by HORNE and as an account payable by CO to HORNE.

On February 6, 1970, the Commissioner forwarded to the taxpayers, as required by law, a statutory notice of deficiency by which he disallowed the deductions claimed by HORNE for 1966, 1967, and 1968 on the grounds that the amounts paid by him to NEW AMSTERDAM represented contributions to capital and not losses incurred in a transaction entered into for profit. Alternatively, the Commissioner invoked the provisions of Section 166 of the Internal Revenue Code of 1954, holding that if the amounts paid by HORNE were found to be loans (a) the loans did not become worthless in the taxable year in which the deductions were claimed, or (b) if worthless, the loans were nonbusiness bad debts and therefore subject to the limitations of Section 1211 of the Internal Revenue Code of 1954.

Within the time provided by Section 6213 of the Internal Revenue Code of 1954 (26 USC § 6213), the taxpayers filed a petition with the Tax Court on May 7, 1970, seeking a redetermination of the deficiencies determined to be due from them by the Commissioner. Jurisdiction was conferred on the Tax Court by Sections 6213(a) and 7442 of the Internal Revenue Code. (26 USC §§ 6213(a), 7442).

The Tax Court held that upon payment to the bonding company HORNE was both an indemnitor and a guarantor, that he did acquire a "remedy over" against CO, and this "remedy over" represented a debt falling within the provisions of Section 166. The Tax Court further held that CO was financially able to pay HORNE during the relevant years and the debts were not worthless, and therefore no deduction was allowed. Section 1211 of the Interal Revenue Code of 1954. (26 USC § 1211).

On February 12, 1973, the Tax Court entered its decision pursuant to the opinion filed November 27, 1972. Within the 90-day period set forth in 28 USC § 7483, on May 11, 1973, the taxpayers filed their Notice of Appeal to the United States Court of Appeals for the Ninth Circuit. Jurisdiction was conferred upon that Court by 28 USC § 2483.

On appeal, the Ninth Circuit affirmed. It held that Section 166 is applicable to payments by an indemnitor regardless of the existence of an independent debt between the corporation and the taxpayer. In view of the Tax Court's determination that the debts were not worthless, no deduction was permitted. On October 25, 1975, appellants filed a petition for rehearing. The court denied the petition for rehearing on March 27, 1978.

REASONS FOR GRANTING THE WRIT

I. The decision of the Ninth Circuit is in conflict with Howell v. Commissioner, 69 F.2d 447 (8th Cir., 1934), cert. denied 292 U.S. 654, on the question of whether payments

under an indemnity agreement are to be given bad-debt treatment; in conflict with Stahl v. United States, 441 F.2d 999 (D.C. Cir., 1970) on the question of the applicability of section 166(d) to the instant transaction; and in conflict with Lutz v. Commissioner, 282 F.2d 614 (5th Cir., 1960), on the question of the applicability of section 162 to the inst ant transaction.

A. Howell v. Commissioner, supra, has long been recognized as the controlling case establishing deductible losses under section 165(c). The distinction between a guarantor on the one hand as opposed to the indemnitor on the other, was stated by the court as follows:

> "Although the ordinary surety or guarantor is a creditor of the principal debtor, the same cannot be true of an indemnitor who does not undertake to assume or discharge the obligations of another, but has, on his own account, contracted to pay a sum of money upon the occurrence of a certain event, usually the happening or the ascertainment of a loss. There is no privity, either actual or implied, between the promisor in the undertaking the loss from the nonperformance of which is indemnified against and the indemnitor, and the latter, if the loss occurs, does not, by payment of it, discharge any one's obligations but his own."

69 F.2d at 451.

The error of the Tax Court, which the Ninth Circuit compounded, was their refusal to recognize the January 20 agreement as a new and independent undertaking by HORNE to NEW AMSTERDAM for which he had no personal obligation prior to the agreement. They did so while at the same time recognizing HORNE's motivation for entering into the agreement to be for the purpose of protecting of his financial integrity and reputation as a real estate developer.

Both the Ninth Circuit and the Tax Court likened HORNE's situation to that of the taxpayer in United States v. Hoffman, 423 F.2d 1217 (9th Cir., 1970). However, the Hoffman case presented a question of "substance over form" and the Ninth Circuit concluded from the facts, that Hoffman was a guarantor even though the bonding agreement referred to him as an indemnitor. The facts of that case reflected that the taxpayer-stockholder agreed to indemnify simultaneously with the execution of the bonding application by the corporation with the surety.

Following the Hoffman case, this court decided United States v. Generes, 405 U.S. 93 (1972), which has striking factual similarities to the Hoffman case. In deciding Generes this court did not disapprove of indemnity losses, or the principal of Howell v. Commissioner, supra, but instead resolved a conflict among the circuits as to the motivation tests to be applied in determining whether a debt is deductible as a business bad debt under section 166.

HORNE's transaction with NEW AMSTERDAM was an independent undertaking by him rather than a simultaneous transaction as was apparent in Hoffman, supra. As such HORNE's case falls within the principal of Howell v. Commissioner, supra, which HORNE maintains creates a conflict which must be resolved by this court.

B. Also following the Hoffman decision, the Court of Appeals for the District of Columbia decided Stahl v. United States, supra, which criticized Hoffman and those cases which made a blanket declaration that the principals of Putnam v. Commissioner, 352 U.S. 82 (1956) applied in all cases where a taxpayer-stockholder made an undertaking (whether or not involving subrogation) in order to protect or enhance his position in the corporation. See also, Stratmore v. United States, 420 F.2d 461 (3d Cir., 1970), cert. denied 398 U.S. 951 (1970).

The Stahl case presents a well-reasoned opinion. While the facts differ from those now before the court, it clearly recites the proposition that section 116 has application only to a bona fide debt existing at the time the transaction was entered into. The court, applying the principal of substance over form, Commissioner v. Conat Holding Co., 324 U.S. 331, 334 (1945), held that a loan of securities by the taxpayer to her brokerage firm which she agreed could be used as part of the capital of the firm, did not create a "loan" or an "indebtedness" within the meaning of section 166. Upon the

ultimate loss of the securities, the court held that section 166 had no application because when the transaction was entered into initially there was no bona fide debt as provided by Treasury Regulations § 1.166-1(c), 26 C.F.R. § 1.166-1(c) (1970), to wit:

> "Only a bona fide debt qualifies for purposes of Section 166. A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. A gift or contribution to capital shall not be considered a debt for purposes of Section 166."

441 F.2d at 1003.

Prior to the January 20 agreement there was no debt existing between HORNE and NEW AMSTERDAM. Moreover, the January 20th agreement did not create a debt but merely a promise by HORNE to hold NEW AMSTERDAM harmless from loss. Until that loss arose there was nothing to which section 166 could possibly have had application.

The loss which ultimately came upon HORNE did not follow from a bona fide debt. Treas. Reg. § 1.166-1 (c). Neither did a bona debt come about by the process of subrogation as set forth in Putnam v. Commissioner, supra. HORNE's loss was real and sustained by him for a valid business purpose.

Since there was no bona fide debt to which HORNE's loss could attach, he maintains that section 166

has no application and that his loss was properly deductible pursuant to section 165(c)(1) or (2). HORNE further maintains that Hoffman, supra, is in conflict with Stahl v. Commissioner, supra, and that this conflict constitutes an additional reason for the granting of the writ.

C. The reasoning of Stahl v. Commissioner likewise creates a conflict between the Hoffman case, on the one hand, and Lutz v. Commissioner, supra, on the other. See also Allen v. Commissioner, 283 F.2d 785 (C.A. 7, 1960). Lutz presented facts of the taxpayer-stockholder paying the debts of a corporation to preserve his credit reputation and standing. The Fifth Circuit allowed such payments as deductions under section 162.

HORNE was primarily and dominantly motivated to enter into the January 20th agreement in order to protect his financial integrity and reputation so that he could remain in real estate development. That motivation (see United States v. Generes, supra) carried over to the time when the payments were made by him under the January 20th agreement. The payments were not made to satisfy his "neighborly amenities, or to heighten his reputation for generosity and opulence." Lutz v. Commissioner. They were made by him for a dominantly motivated business purpose. Therefore the payments are also deductible pursuant to section 162.

The holding of the Ninth Circuit to the contrary in Hoffman puts it

in conflict with the Fifth Circuit which conflict should be resolved by this court.

II. The Ninth Circuit's opinion in United States v. Hoffman has created confusion and uncertainty in an important area of federal income tax law which should be settled by this court.

The opinion of the court in United States v. Hoffman was per curiam and as such the opinion does not set forth the Ninth Circuit's reason in detailed analysis with respect to its approach to an important issue of federal income tax law of first instance. Before Hoffman the question of an "indemnitor" being the same as a "guarantor" had not been decided.

In HORNE's case, the Ninth Circuit had an opportunity to speak with clarity on the issue; however, it is respectfully submitted that the court's reasoning is fundamentally wrong as a matter of law. In the Ninth Circuit's opinion it was stated that HORNE sought to distinguish Putnam v. Commissioner, supra, and United States v. Hoffman, on the grounds that the essence of the Putnam rule was that the taxpayer as guarantor acquired upon payment a claim against the corporation by subrogation, which was the ultimate "debt" that became worthless. It was further pointed out that:

> "the loss resulting from [the worthlessness of a nonbusiness debt] . . ..includes not only any loss sustained by the obligee of

> the debt but any loss sustained by a third party. [The court concluded that] the section is triggered by the worthlessness of the principal debt, and no independent debt between principal debtor and the third party, created by subrogation, is necessary." [sic]

HORNE submits the court's analysis to be fundamentally wrong. The Ninth Circuit has referred to section 166 (d)(1) as a source definition of the character of HORNE's loss. However, HORNE submits that those provisions relate to the treatment to be accorded the loss, not its definition. Section 166(d)(2) defines the nature of the nonbusiness bad debt to be a debt created or acquired in connection with a trade or business of the taxpayer; or a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business. Treasury Regulation § 1.165-5 refines further, by providing:

> " * * *
> (b) Nonbusiness debt defined--For purposes of section 166 and this section, a nonbusiness debt is any debt other than--
>
> "(1) A debt which is created, or acquired, in the course of a trade or business of the taxpayer, determined without regard to the relationship of the debt to a trade or business of the taxpayer at the time when the debt becomes worthless; or
>
> "(2) A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

"The question whether a debt is a nonbusiness debt is a question of fact in each particular case. The determination of whether the loss on a debt's becoming worthless has been incurred in a trade or business of the taxpayer shall, for this purpose, be made in substantially the same manner for determining whether a loss has been incurred in a trade or business for purposes of section 165(c)(1). For purposes of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If th at relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception provided by that subparagraph. * * * (Emphasis supplied)

Treas. Reg. § 1.166-5, T.D. 6500, 26 C.F.R. § 1.166-5 (1960)

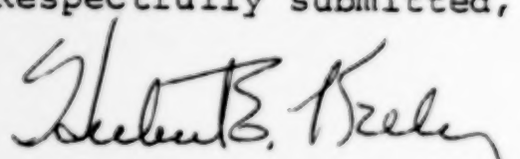
HORNE maintains that the record is uncontradicted in its support that prior to the January 20th agreement COINC, CORP and CO were in irreversible financial difficulty and for all practical purposes bankrupt. The "debt" to which the Ninth Circuit has referred was at that time worthless. Had HORNE acquired the debt at that time section 166 would not have applied as it is well established that section 166 does not apply where the debt was worthless when acquired. Eckert v. Burnet, 283 U.S. 140 (1931).

The foregoing constitutes additional reason why HORNE's loss does not fall within the debt provisions of section 166. More importantly, however, the Ninth Circuit has not spoken in Hoffman, supra, with clarity on the one hand while at the same emasculating the losses of true indemnitors under section 165(c). That coupled with the additional questions and conflicts raised by Stahl v. Commissioner, supra, and Lutz v. Commissioner, supra, taken together with the possibility of conflict with United States v. Generes, supra, creates an atmosphere of uncertainty and confusion in the area of federal income tax law which should be resolved by this court.

CONCLUSION

For the foregoing reasons, it is respectfully prayed that this court grant this petition for a writ of certiorari to the United States Court of Appeals for the Ninth Circuit herein.

Respectfully submitted,



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June 23, 1978

CERTIFICATION OF SERVICE

I, HUBERT E. KELLY, attorney for Appellants, hereby certify that I served by mail four (4) true and correct copies of the PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT on counsel for Appellee, Commissioner of Internal Revenue, on the 23rd day of June, 1978, by placing said copies in an envelope addressed to M. Scott Ferguson, Assistant Attorney General, Tax Division, United States Department of Justice, Washington, D.C. 20530; said envelope was then sealed and deposited in the United States Post Office at Phoenix, Arizona, on the aforesaid day with the postage thereon fully paid.

Hubert E. Kelly
Attorney for Appellants

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59 T. C. No. 32

UNITED STATES TAX COURT

M. SETH HORNE AND MAURINE D. HORNE, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 2645-70

Filed November 27, 1972

Petitioner (husband) was a partner in a three-man firm. The three partners, as individuals, owned all the stock in COINC, which, in turn, owned all the stock in CORP and CO. All three corporations performed construction work. N/A, a bonding company, wrote bonds for all three corporations. All three corporations indemnified N/A on cross-indemnity agreements. In 1960, CO notified N/A that it, N/A, would have to perform on its bond. Because the three corporations were close to insolvency, N/A asked COINC's stockholders to indemnify it. Only petitioner agreed to do so. As a part of the sorting-out process that followed, the partnership was dissolved, the partnership property was distributed, the partners exchanged interests in various properties, and the corporations were reorganized. Concerning the reorganization, petitioner received all the stock in CO--to which substantially all the assets of COINC and CORP had been transferred--in

return for all his stock in COINC. At approximately the same time, petitioner entered into an agreement whereby he became jointly and severally liable with CO, for any losses incurred by N/A on its bond. CO continued in existence. COINC and CORP became inactive. Years later the petitioner paid N/A roughly $600,000 and recouped less than half of this amount from CO.

Held, on the facts, petitioner's promise to indemnify the bonding company was not part of the purchase price of the CO stock. Estate of McGlothin v. Commissioner, 370 F.2d 729 (C.A. 5, 1967), affirming 44 T.C. 611 (1965) distinguished. Nor was petitioner compensated for his losses. Rather the losses on the so-called indemnity agreement must be treated as bad debt losses falling within sec. 166, I.R.C. 1954, and disallowed as such because they were not worthless in the years at issue. Petitioner was as much a guarantor as an indemnitor. Putnam v. Commissioner, 352 U.S. 82 (1956), applicable.

Hubert E. Kelly and Charles L. Arnold, for the petitioners.

Harold E. Patterson, for the respondent.

DAWSON, Judge: Respondent determined deficiencies in petitioners' Federal income taxes for the taxable years 1966, 1967, and 1968 in the amounts of $56,280, $23,378, and $66,078, respectively.

Petitioners have conceded one issue. The only issue remaining for decision is whether they are entitled to a deduction for amounts paid in connection with an indemnity agreement entered into by them on behalf of their wholly owned corporation. The issue is argued under sections 162, 165, 166, and 212, Internal Revenue Code of 1954.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts, the supplemental stipulation of facts, and the exhibits attached to both are incorporated herein by this reference. We have limited our findings to those facts which are pertinent to our decision.

The petitioners, M. Seth Horne and Maurine D. Horne, are husband and wife and, at the time of filing the petition herein, were residents of Phoenix, Arizona. They filed joint Federal income tax returns for the years 1966, 1967, and 1968 with the district director of internal revenue at Phoenix, Arizona.

M. Seth Horne (herein called petitioner) is a real estate developer and investor. He became interested in the field when trying to start up a restaurant in the Washington, D. C. area. Near the end of World War II, he surveyed the real estate business prospects in that area and began development operations on a full-time basis.

In 1947, petitioner was joined by Harold A. Naisbitt, an accountant, in a joint venture for the development of

a piece of property in Fairfax County, Virginia. About two years later, W. B. Ingersoll, a practicing dentist, purchased a part of petitioner's interest in the joint venture. On January 5, 1951, Horne, Ingersoll and Naisbitt formed a general partnership (herein called HIN or the partnership) to engage in the business of real estate development. Petitioner had a 65.6 percent interest in the partnership; Ingersoll had a 20 percent interest; and Naisbitt had a 14.6 percent interest. Petitioner acted as general manager, Naisbitt handled the accounting problems, and Ingersoll was available for consultation. So long as petitioner was a partner in HIN, he did not engage in any other business activities on a strictly individual basis. Although he owned certain rights concerning real property in his own name (as recited in the indemnity agreement detailed below), he owned them in conjuction with his partners. Nevertheless, due to his participation in HIN, he remained in the real estate business.

The business activities of the partnership consisted of acquisition, zoning, financing, and management of real properties. Its first large-scale project was an apartment complex and shopping center situated on 100 acres near Seven Corners, Virginia.[1]

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[1] The partnership's returns for 1952 and 1953 state that its principal business activity was the renting of business furniture. Its returns for 1954 through 1960 state that its principal business activity was the performance of executive

James Stewart and Co., Inc. (herein called COINC) is a corporation organized under the laws of the State of New York in 1913. It conducted a general engineering and contracting business; and by 1951 it had acquired a respected international reputation. In 1927, COINC caused James Stewart Corporation (CORP) to be organized pursuant to the laws of the State of Delaware. CORP operated as a wholly-owned subsidiary of COINC. It, too, performed general engineering and contracting work.

In 1951, soon after the formation of HIN, the petitioner and his partners became interested in acquiring COINC, thinking that COINC's construction activities would complement the partnership's real estate activities. On January 1, 1952, they purchased all of the common stock of COINC, consisting of 12,168 shares, and 2,055 shares of preferred stock for a total of $150,000. Later, on December 31, 1954, they purchased the remaining 4,533 shares of preferred stock for an additional $150,000. After an adjustment due to taxes assessed against COINC, the total purchase price for both common and preferred stock amounted to $246,406.25. All stock was acquired in the names of the individual partners according to each partner's interest in HIN. Petitioner's basis in the COINC stock was

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services for COINC, discussed in the text below. These statements are obviously not controlling. Furthermore, respondent apparently does not object to petitioner's characterization of the partnership's business as real estate development.

$194,442.50.

On July 28, 1952, COINC--then controlled by petitioner and his partners in HIN--caused James Stewart Company (CO) to be incorporated under the laws of the State of Texas. Like CORP, CO was COINC's wholly-owned subsidiary and performed construction and general contracting work. The plan was for COINC to base its operations in New York and perform contracts in the Eastern States, for CORP to base its operations in Chicago and perform contracts throughout the Midwest, and for CO, based in Texas, to service the Western part of the country.

From the start petitioner, Ingersoll, and Naisbitt were active in the management of COINC as members of its board of directors. Also, petitioner was immediately made vice president of COINC. He held that office until 1955, when he was elevated to president and chairman of the board--positions which he held through 1960. Petitioner and Naisbitt were also members of the board of both CORP and CO. In 1953, petitioner was elected vice president of CORP and, in 1954, chairman of its board. Petitioner was president of CO from its inception.

As for the relationship between the partnership and the corporations, HIN was the manager of COINC, and CORP and CO were its operational arms. HIN engaged in all phases of real estate development--though after acquiring COINC, a great deal of the partners' time was devoted to overseeing the parent and its subsidiaries. The corporations only performed construction work, except CO developed some land on the Papago Indian Reservation (Papago

Indian Project), near Sells, Arizona, and some mining claims near Tombstone and Camp Verde, Arizona.

For the years 1953 through 1960, the net income of COINC, CORP, and CO, exclusive of any net operating loss deductions, was as follows:

Year	COINC	CORP	CO
1953	$ 32,554.97	$ 8,707.20	$ 33,773.99
1954	9,391.29	121,644.15	(52,543.84)
1955	36,723.78	19,567.59	(77,982.91)
1956	38,379.79	236,126.55	13,621.82
1957	84,020.79	69,316.32	98,356.31
1958	(122,994.30)	(329,306.37)	(230,013.29)
1959	(39,547.41)	(10,474.26)	(165,019.40)
1960	(75,967.18)	(138,196.22)	(159,282.89)

During the years 1952 through 1960, petitioner received no compensation of any kind from COINC, CORP, or CO for services rendered. Nor did Ingersoll or Naisbitt receive any compensation. Also, none of the corporations paid any dividends during those years. CORP and CO did, however, pay management fees to COINC, and COINC in turn paid management fees to the partnership. The following schedule shows the fees paid by COINC to HIN:

Year	Management Fee
1952	$28,801.63
1953	33,499.92
1954	55,500.00
1955	50,000.00
1956	50,000.00
1957	61,303.94
1958	50,000.00
1959	55,000.00
1960	51,001.10

The partnership was operated on the accrual basis of accounting and used the calendar year as its taxable year. Its Federal income tax returns for the years 1952-1960 reveal the following:

Year	Total Income	Total Deductions
1952	$ 77,832.21	$ 57,903.42
1953	93,350.19	71,834.25
1954	104,044.67	72,945.84
1955	108,690.02	130,835.61
1956	191,988.41	132,255.45
1957	126,814.85	114,677.50
1958	84,000.00	119,008.29
1959	131,072.27	100,837.19
1960	156,124.04	116,322.48

Year	Petitioner's Share of Ordinary Income[1]	Petitioner's Share of Capital Gains[2]	Payments From Partnership to Petitioner
1952	$ 5,937.29	$ 871.73	--
1953	5,484.86	(506.37)	--
1954	11,541.63	1,574.40	--
1955	(14,527.50)	9,534.82	$ 16,200.00
1956	39,184.82	12,262.49	20,700.00
1957	6,541,17	12,262.49	26,492.85
1958	(37,999.98)	14,633.96	23,200.00
1959	19,834.21	122,590.14	3,803.37
1960	26,109.80	56,565.76	17,795.60

[1]After payments to partners

[2]Including section 1231 gains.

In the conduct of their construction business the three corporations were required to furnish performance bonds on the jobs that they undertook. All three corporations obtained bonds from New

Amsterdam Casualty Company (herein called New Amsterdam or the bonding company). COINC and CORP agreed to indemnify New Amsterdam for any losses incurred as surety for CO, CORP and CO agreed to indemnify New Amsterdam from any losses incurred as surety for COINC.

Beginning in 1958 and continuing through 1960, the corporations suffered financial losses; by October 1960 they were in severe financial trouble. For its taxable year ended December 31, 1960, CO had a net operating loss of $539,090.21, inclusive of a net operating loss carry-over of $379,807.32. CO's difficulties were due to losses incurred in connection with construction work in Southern California and the Papago Indian Project. In all, CO's net worth was adversely affected by approximately $1.75 million.

As a consequence of the above difficulties, in the summer of 1960, petitioner and Naisbitt notified New Amsterdam that CO could not complete all its contracts and that it, as surety, would probably have to make some performance in accordance with the bonds written on CO's behalf. They also informed New Amsterdam that COINC and CORP did not have sufficient funds to meet their obligations as indemnitors under the cross-indemnity agreements. At this point, the bonding company estimated its "exposure" at approximately $1-1/5 million. Also at this point in time none of the partners in HIN, including the petitioner, were individually liable to the bonding company for amounts paid on performance bonds.

To better secure itself, New Amsterdam requested petitioner, Ingersoll, and Naisbitt to contract to indemnify it for

any loss incurred on the three corporations' bonds. Ingersoll and Naisbitt balked. Petitioner, however, acceded. He did so realizing that unless he agreed the corporations would be taken over by the bonding company, their assets would be liquidated, and they would probably end up in bankruptcy. Not only would he lose his investment in COINC but, most importantly, his credit reputation would be ruined. Thus, because the ability to borrow large amounts of money is crucial to the conduct of a real estate development business, he could no longer participate in such a business--on an individual basis or as a major figure in a partnership or corporation.

Negotiations between petitioner and New Amsterdam concerning the terms of the indemnity agreement commenced in October 1960 and continued until January 20, 1961, when an agreement was signed. Naisbitt participated in the early stages of the negotiations in order to help effectuate the separation of his and Ingersoll's affairs from the affairs of the petitioner. Sometime before January 20, 1961, the petitioner began the process of acquiring clear title to a tract of land (the Shirley Highway Property) of "very great value." The land is located on Shirley Memorial Highway in the City of Alexandria, Virginia. It was being acquired "out of the partnership."[2]

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[2] The details of this transaction are unclear. It appears, however, that the land was held in co-tenancy by the petitioner, Ingersoll, and Naisbitt, and that petitioner was in fact acquiring title from them.

Meanwhile, on November 16, 1960, New Amsterdam instituted a suit against CO and Mayer Central Building Corporation in the United States District Court for the District of Arizona asserting, among other things, that it, New Amsterdam, was not liable on bonds executed in connection with a contract between CO and Mayer.

The January 20th indemnity agreement between petitioner and New Amsterdam recites as follows: That CO entered into eight construction contracts, including the Mayer Central Building Corporation contract, for a total contract price of approximately $12 million and that New Amsterdam was surety on those contracts; that, in addition, New Amsterdam was surety on the Papago Project, that claims had been and would be made against New Amsterdam on its bond, and that those claims would exceed $500,000; that COINC had previously agreed to act as indemnitor of New Amsterdam for losses sustained as surety for CO, that CORP had previously agreed likewise, that CORP and CO had previously jointly and severally agreed to act as indemnitor of New Amsterdam for losses sustained as surety for COINC, and that CO had previously agreed to act as indemnitor of New Amsterdam for losses sustained as surety for it, CO; that CO and CORP were both wholly-owned subsidiaries of COINC and that petitioner, Ingersoll, and Naisbitt were the sole shareholders of COINC; that New Amsterdam had filed the above-mentioned suit against CO and Mayer Central Building Corporation; that the petitioner was "in the process of acquiring" clear title to the Shirley Highway Property; that CORP presently held certain rights under an agreement to purchase certain mining claims (the Charleston Claims); that petitioner, Ingersoll, Naisbitt, and

COINC, together with another individual, presently held interests in certain rights under an agreement to purchase agriculture lease rights in property located in Yuma County, Arizona (the Hall-Morrison Property); that petitioner, Ingersoll, Naisbitt, and COINC, together with another individual, presently owned certain real property and held certain interests in grazing lands (collectively referred to as the Palomas Ranch Property) and that said property was subject to a mortgage; that CO presently held certain rights under a joint venture agreement with Freesh Land Ventures, Inc., in land (the Papago Farm Property) owned by the Papago Indian Tribe; and that CO presently held a lease of mineral rights in Yavapai County, Arizona (the Sodium Sulfate Mine Property) and an option involving said property.

The indemnity agreement further provides, in summary, as follows:

1. The petitioner will obtain clear title to the Shirley Property and convey it to a trustee, the Mount Vernon Band and Trust Company of Fairfax County, Virginia, to be held as security for his promise to indemnify New Amsterdam.

2. Petitioner and CO will cause CORP to convey to CO CORP's rights to and interest in the Charleston Claims.

3. Petitioner and CO will cause COINC to convey to CO CORP's rights to and interest in the Hall-Morrison Property and the Palomas Ranch Property, plus (1) any amounts due from New Amsterdam to COINC for past services ren-

dered[3] and (2) a life insurance policy on petitioner's life, naming COINC as beneficiary (petitioner and CO agreed to pay all premiums as they became due and to designate New Amsterdam as the new beneficiary).

4. Upon receiving the assets named in 2 and 3 above, CO will transfer such assets to a trustee, a Phoenix law firm, so as to secure CO's promise to indemnify New Amsterdam.

5. CO will endorse and deliver to New Amsterdam two promissory notes executed by one Lawrence D. Mayer and his wife Pauline, each in the sum of $50,000.

6. CO will assign all balances due and to become due on the eight construction contracts recited above; then, after all of the above.

7. New Amsterdam will dismiss with prejudice the action against CO and Mayer Central Building Corporation.

8. New Amsterdam will fulfill the obligations of CO in connection with the eight construction contracts recited above, in accordance with its obligation as surety.

9. New Amsterdam will release COINC and CORP from their cross-indemnity agreements.

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[3] Evidently, COINC occasionally helped in the performance of contracts taken over by New Amsterdam, as surety, from other construction companies.

10. New Amsterdam will release CO and CORP from their cross-indemnity agreement, except as to five bonds executed in connection with five contracts, none of which are included among the eight construction contracts recited above.

11. CO and petitioner jointly and severally agree to pay to New Amsterdam (1) amounts expended by New Amsterdam pursuant to bonds issued in connection with the eight contracts recited at the beginning of the agreement, (2) all amounts for which CO is obligated under its separate indemnity agreements,[4] and (3) interest on all of said amounts at the rate of 4 percent per annum.

12. All amounts due from CO and petitioner on the above indemnity obligation will be paid in five semi-annual installments, beginning five years after the date of this agreement.

Prior to the signing of the January 20th indemnity agreement, but contemporaneous with the negotiation of the agreement, the partners of HIN agreed, first, to dissolve[5] the partnership and distribute certain properties "owned by the partnership" to the individual partners in accordance with the following schedule:

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4 This apparently includes amounts expended pursuant to the bond issued in connection with the Papago Indian Project.

5 While we note that the pertinent agreement is titled "Memorandum Agreement of Partial Liquidation of Partnership Assets," we accept the parties' characterization of this event as a complete dissolution of the partnership.

	Property	Percentage Interest Distributed to: Petitioner	Ingersoll	Naisbitt
1.	Esso Station land at NE corner of Patrick Henry Dr. and Arlington Blvd., Fairfax Co., Va.	65.6	20.0	14.4
2.	Hot Shoppe land at SE corner of Patrick Henry Dr. and Arlington Blvd., Fairfax Co., Va.	65.6	20.0	14.4
3.	Foster Tract between Arlington Blvd. and South St., Fairfax Co., Va.	65.6	20.0	14.4
4.	Parcel 7 of Willston South, at SW corner of Patrick Henry Dr., and Arlington Blvd., Fairfax Co., Va.	65.6	20.0	14.4

	Property	Percentage Interest Distributed to: Petitioner	Ingersoll	Naisbitt
5.	Parcel 8 of Willston South, Fairfax Co., Va.	18.0	47.5	34.5
6.	Medical Clinic land, Houston, Texas	65.6	20.0	14.4
7.	Mohave Property, Mohave Co., Arizona	100		
8.	Palomas Ranch Property, Yuma & Maricopa Counties, Arizona	100		
9.	Eagle Tail Ranch, Yuma and Maricopa Counties, Arizona	100		
10.	South Phoenix Property, Pinal County, Arizona	100		

	Property	Percentage Interest Distributed to: Petitioner	Ingersoll	Naisbitt
11.	Casa Grande Property, Pinal County, Arizona	100		
12.	Arizona Land Title Bldg., Tucson, Arizona	100		

Second, the petitioner, Ingersoll, and Naisbitt exchanged interests in certain parcels of land, including those six parcels listed above as not owned 100 percent by petitioner. Petitioner gave up his interest in part of the "Esso Station land" and in three tracts near land owned by Naisbitt off Arlington Boulevard in Fairfax County, Virginia.[6] In return, petitioner received the interests of Ingersoll and Naisbitt in the remaining portion of the "Esso Station land," the "Hot Shoppe land," the "Foster Tract," "Parcel 7 of Willston South," "Parcel 8 of Willston South," the "Medical Clinic land," and the "Shirley Highway Property." Both the dissolution/distribution and the exchange of interests occurred pursuant to agreements dated January 1, 1961.

Shortly after the signing of the January 20th indemnity agreement, the petitioner, Ingersoll, and Naisbitt agreed to a separation of CO from COINC and CORP. The petitioner received all the stock in CO--heretofore held by COINC, which was in turn owned by all three of the partners. Ingersoll and Naisbitt were left with all the stock in COINC and thus with the ownership of both COINC and CORP. As a part of this "settlement," the following assets, worth at least $555,000, were transferred from COINC and CORP (through COINC) to CO: The Papago Farms Property, the Palomas Ranch Property, the Hall-Morrison Property, the Charleston Claims, a life insurance policy on petitioner's life and

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6 The three tracts apparently did not come out of the partnership.

accounts receivable due from New Amsterdam. In return, COINC received additional stock in CO. Evidently these shares, in addition to all other shares of CO stock held by COINC, were distributed to petitioner in redemption of his shares in COINC. This separation was effective as of December 31, 1960, though not agreed to until January 26, 1961. After the separation there were virtually no assets left in COINC and CORP, and both companies became inactive. Ingersoll and Naisbitt terminated their relationship with CO, and petitioner resigned his offices with COINC and CORP.

After the execution of the indemnity agreement, CO went about its construction business. Petitioner directed the affairs of the company as its president and principal managing officer. During each of the years 1961, 1962, and 1963, he received $12,000 per year in salary. For 1964, 1965, and 1966 he received no salary. In 1967 he received a salary of $9,500. Petitioner's wife received $4,800 as salary in 1963.

As of January 1, 1960, CO was, however, insolvent in that liabilities exceeded assets by approximately $530,000, and the company was unable to meet its debts as they matured. At the end of calendar year 1962, CO had a net operating loss of $677,000. Since CO had income amounting to $457,000 in 1964, this loss was carried forward.

In accordance with the bonding arrangement and its agreement with petitioner and CO, New Amsterdam made payments on behalf of CO. Although New Amsterdam originally anticipated having to pay out $1-1.5 million, the total amount of the payment was not determined until 1964 or 1965. Ultimately it paid out only $597,430.44.

Petitioner, pursuant to the January 20th indemnity agreement, paid the following amounts to New Amsterdam: $237,434.46 in 1966, $121,749.22 in 1967, and $238,246.76 in 1968. The money came in large part from the sale of the Shirley Highway Property in 1964. Petitioner then deducted one-half of these amounts, that is, $118,717, $60,875, and $119,123, in 1966, 1967, and 1968, respectively, as "losses pursuant to Indemnity Agreement of 1/20/61."

The remaining halves were treated as loans to CO by petitioner and as accounts payable by CO.[7]

In 1963, petitioner organized the Seth Horne Development Corporation under the laws of the State of Arizona to perform real estate development work. In March 1967, CO was merged into Seth Horne Development Corporation, and the latter adopted the former's name--James Stewart Company. (We will refer to this Arizona version of CO as CO(ARIZ).) At all pertinent times the petitioner was the majority shareholder of CO(ARIZ).

The total assets, liabilities, capital, and surplus (or deficit) of CO and its successor, CO(ARIZ), as of 1960 through 1967 as reflected in its returns, were:

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[7] At first, in 1966, CO treated the entire amount paid by the petitioner to the bonding company during that year (i.e., $237,434.46) as paid-in capital. This was corrected the next year, so that one-half of the amount paid to the bonding company was treated as paid-in capital and one-half as an account payable.

	12-31-60	12-31-61	12-31-62	12-31-63*
Total Assets	$ 947,212	$1,651,782	$1,761,341	$3,591,409
Total Liabilities	$1,479,531	$1,675,044	$1,876.291	$3,162,935
Capital Stock	25,000	580,000	580,000	580,000
Paid in Capital	-	-	-	-
Surplus (Deficit)	(557,319)	(603,262)	(694,950)	(151,526)
Total Liabilities and Capital	$ 947,212	$1,651,782	$1,761,341	$3,591.409

	12-31-64	12-31-65	12-31-66	12-31-67
Total Assets	$2,825.849	$2,772,814	$2,779,001	$3,663.941
Total Liabilities	$2,568,189	$2,357,178	$1,975,541	$3,042,209
Capital Stock	580,000	580,000	580,000	605,000
Paid in Capital	-	-	237,434	179,592
Surplus (Deficit)	(322,340)	(164,364)	(13,974)	(162,860)
Total Liabilities and Capital	$2,825,849	$2,772,814	$2,779,001	$3,663,941

*Per amended return

The increase in capitalization from $25,000 to $580,000 reflects the treatment of the transfer of assets from COINC to CO as a purchase of additional shares.

Stewart-Southern, Inc. (SOUTHERN) was a California corporation which was organized in 1955 and, in 1961, was owned 50 percent by petitioner, his relatives, and his friends (the Horne group) and 50 percent by outsiders. In August 1961, CO purchased the stock of the Horne group in SOUTHERN for $441,303.75. In March 1963, CO bought the remaining stock for approximately $450,000. On June 14, 1963, SOUTHERN was liquidated and its assets transferred to CO. By far the most important of these assets was a piece of property in San Diego, California, known as the Rose Canyon Warehouse, having a book value in excess of $2,000,000. Also in June 1963, CO gave to petitioner a fourth mortgage on the Rose Canyon Warehouse.[8] It was provided, however, that the mortgage would be null and void if the mortgagor, CO, paid New Amsterdam the sum of $404,144 according to the terms and conditions of the indemnity agreement between petitioner and New Amsterdam.

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[8] The three prior mortgages existed as follows: The first mortgage, dated September 1, 1957, was executed in favor of the Bank of America Trust and Savings Association to secure payment of promissory notes totaling $3,500,000. It is not known to what extent these notes were paid. The second mortgage, dated March 28, 1963, went to the "outsiders," the former owners of 50 percent of SOUTHERN to secure payment of three purchase notes

At this time, June 1963, a costly suit of the Papago Indian Tribe was threatened against CO. The reason for giving the fourth mortgage to petitioner was to protect the property from execution in the event a future law suit was lost.

The merger agreement between CO and Seth Horne Development Corporation, leading to the creation of CO(ARIZ), provided, among other things, for the petitioner to be compensated for the release of the fourth mortgage by the receipt of additional shares in Seth Horne Development Corporation (soon to be CO(ARIZ)). A release was necessary in order to obtain refinancing on the property. The mortgage was released on or about June 30, 1967. At that time there remained less than $450,000 of indebtedness on the Rose Canyon Warehouse.

At all times from 1966 to 1968, CO and its successor, CO(ARIZ), had a net worth in the accounting sense (excess of assets over liabilities) of over $600,000, and in 1971 its net worth was approximately $5,000,000.

Respondent disallowed the claimed losses with this explanation:

> The deductions of $118,717.00, $60,875.00, and $119,123.00 which you claimed for the taxable years 1966, 1967, and 1968 respectively as indemnity loss resulting from trans-

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amounting to $750,000, exclusive of interest. The third mortgage, dated June 4, 1963, went to the Horne group in connection with the purchase of SOUTHERN to secure payment notes worth $441,303.75.

fers of those amounts to the New Amsterdam Casualty Company for or on behalf of The James Stewart Company, [CO] * * * are disallowed. It is determined that the funds transferred represented contributions to capital rather than losses incurred in a transaction entered into for profit. If, however, it is found that such transfers were loans, it is determined that a bad debt deduction is not allowable under Section 166 of the Internal Revenue Code because it has not been established that the debt became worthless in the taxable year in which the deduction was claimed. If, however, it is found that such transfers were loans which became worthless in the taxable year in which the deduction was claimed, it is determined that the debt was a nonbusiness bad debt since the debt was a personal loan and was not created in connection with your trade or business. In the latter event, the losses of $118,717.00, $60,875.00 and $119,123.00, respectively, are subject to the limitations of Section 1211 of the Internal Revenue Code.

OPINION

In late 1960 the petitioner, Seth Horne, held a majority interest in a three-man partnership, HIN. Petitioner also held interests in the Shirley Highway Property, the Hall-Morrison Property, and the Palomas Ranch Property. The three partners, as individuals, owned all the stock of COINC, in proportion to their respective interests in HIN. COINC, in turn, owned two subsidiaries, CORP and CO. CORP and CO paid management fees to COINC, and COINC paid management fees to HIN. The

principal business of HIN was the holding and development of real estate, including the performance of construction jobs. Petitioner's business, as of 1960 and early 1961, was the same as that of the partnership.

Beginning in 1958 and continuing through 1960, the three corporations incurred large operating losses. For its taxable year ended December 31, 1960, CO alone had a net operating loss of $539,090.21, inclusive of loss carryovers.

In the summer of 1960, CO notified its bonding company, New Amsterdam, that it could not complete certain contracts and that the bonding company would have to step in. New Amsterdam, upon discovering that the three corporations were in severe financial trouble, asked the three stockholders of COINC to become personally liable for amounts paid on the surety bonds. Petitioner's fellow stockholders (and partners) refused. Petitioner, however, agreed to indemnify the bonding company in order to protect his credit reputation and thus his business as a developer.

It was then agreed among the parties--the petitioner, his partners, and the bonding company--(1) that petitioner would obtain clear title to the Shirley Highway Property and transfer it to a trust as security for his (the petitioner's) promise to indemnify New Amsterdam; (2) that COINC and CORP (through COINC) would transfer certain properties and accounts receivable having a fair market value in excess of $555,000 to CO; (3) that petitioner's stock in COINC would be completely redeemed in exchange for all the stock in CO; (4) that COINC, CORP, and the other

two shareholders/partners would not be liable to New Amsterdam; (5) that petitioner would indemnify New Amsterdam. Among the partners it was also agreed that HIN would be dissolved; that certain properties would be distributed to the partners, who would then hold some properties as co-tenants; and that they would exchange interests in those parcels held in cotenancy so that petitioner would own certain parcels "free and clear." All of the above was accomplished. Afterwards, the former partners went their separate ways. The petitioner rebuilt CO's construction business and, when the losses on the bonds were established, reimbursed New Amsterdam. Upon the advice of counsel the petitioner treated one-half of his indemnity payments as loans due from CO and one-half as ordinary losses. He has collected some money from CO, but not yet one-half of the amounts paid. The Commissioner disallowed the claimed loss deductions.

The petitioner, through his able counsel, takes a shotgun approach. He contends that the amounts in question are deductible under section 165(c)(1) and (2) or, alternatively, under section 212 or, perhaps more appropriately, under section 162. He argues that section 166, Putnam,[9] and Generes[10] are inapplicable.

Respondent argues as follows: First, the losses on the indemnity agreement are

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9 Putnam v. Commissioner, 352 U.S. 82 (1956).

10 United States v. Generes, 405 U.S. 93 (1972).

part of the purchase price of CO's stock. Second, the petitioner suffered no losses. He was adequately compensated for the indemnity payments that he made. Third, if the losses are deductible at all, they are deductible only under section 166. He contends that the petitioner must lose under section 166, however, because the debts in question are not worthless. Finally, he claims that if the debts are worthless, they are nonbusiness rather than business bad debts.[11]

To begin with, we disagree with respondent that the losses on the indemnity agreement must be treated as a part of petitioner's basis in the CO stock. While the facts of the sorting-out process which followed the corporations' financial crisis are somewhat confusing, we are convinced, after carefully reviewing them, that petitioner's promise to indemnify New Amsterdam was not partial consideration for the subsidiary's stock, which Naisbitt and Ingersoll agreed would be transferred from COINC to petitioner in exchange for petitioner's COINC stock. Naisbitt and Ingersoll were never personally liable to New Amsterdam as indemnitors or guarantors of any of the corporations' debts; there-

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[11] The tax consequences of the corporate reorganization are not directly at issue in this case.

Respondent does not argue that the losses, if allowed, are capital losses because they are an outgrowth of the earlier, essentially capital transaction. See Arrowsmith v. Commissioner, 344 U.S. 6 (1952); Wener v. Commissioner, 242 F.2d 938 (C.A. 9, 1957); Rees Blow Pipe Mfg. Co.,

fore, the exchange of stock was not conditioned on petitioner's indemnity promise as consideration for New Amsterdam's promise to release Naisbitt and Ingersoll. In other words, there was no three-way agreement. Also Naisbitt and Ingersoll were not purchasing the release of COINC and CORP from their cross-indemnity agreements. It is apparent that both corporations, after having transferred their assets to CO, would be abandoned. Furthermore, there is no indication that New Amsterdam insisted upon the reorganization (petitioner did this) or that the transfer of assets from COINC and CORP to CO depended upon petitioner's entering into the agreement. Cf. Estate of McGlothin v. Commissioner, 370 F.2d 729 (C.A. 5, 1967), affirming 44 T.C. 611 (1965); Albert J. Harvey, Jr., 35 T.C. 108 (1960).

In Estate of McGlothin, supra, the taxpayer, a stockholder of P corporation, guaranteed the market value of certain assets owned by P as part of a merger between another corporation and P. His losses on the guaranty agreement was a critical condition necessary for the acquisition of the other corporation's stock by the taxpayer. Here we find, to the contrary, that the indemnity agreement, though contemporaneous with, was not consideration for the stock received in the reorganization.

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41 T.C. 598 (1964), affd. 342 F.2d 990 (C.A. 9, 1965). Nor does he argue that the indemnification of the bonding company and the losses pursuant thereto represent some sort of unusual contribution to capital. See J. Meredith Siple, 54 T.C. 1 (1970), and cases cited therein.

The case of Albert J. Harvey, supra, is even farther afield. In Harvey, the taxpayer was an employee, director, and major shareholder of H&O corporation. H&O being in need of funds, the taxpayer requested a friend to personally guarantee a loan from a bank to H&O. In consideration for the friend's guaranty, all the shareholders, including the taxpayer, transferred one-half of their stock to the friend. The taxpayer then agreed to indemnify the friend against any loss by reason of the latter's guaranty of the loan. In consideration for this agreement to indemnify, the friend assigned to the taxpayer all the H&O stock which he, the friend, had previously acquired in return for his guaranty. H&O went bankrupt; the friend paid off on his guaranty; and the taxpayer paid the friend in accordance with the indemnity agreement. On these facts we held that the losses on the indemnity agreement were part of the purchase price of the stock received from the friend:

> The net effect of the entire transaction * * * was that petitioner, being a substantial shareholder and director of H&O, was able to obtain additional funds for H&O by pledging his property and in return he received stock of H&O. In substance, this transaction constitutes an acquisition of H&O stock by petitioner for his guaranty of the H&O loan.
>
> * * * * * * *
>
> Petitioner, by his indemnity agreement, assumed a contingent liability and thus acquired the H&O stock without making any immediate payment therefor.
> [Albert J. Harvey, supra at 112-113.]

We find no such tic-for-tac consideration in this case.

We also disagree with the contention that petitioner was adequately compensated by CO for the amounts paid on the indemnity agreement and that, therefore, he suffered no losses. Respondent points to the fact that in 1963 petitioner was given a fourth mortgage on a warehouse in southern California. Later, the petitioner released the mortgage in order to help CO's successor obtain financing, receiving in return additional shares in the successor. Petitioner's explanation is that the fourth mortgage was of indeterminable value and was given simply to further protect the property from execution in connection with a foreseeable law suit. The facts are laid out in sufficient detail in our findings of fact. Because we believe the testimony given on petitioner's behalf, we find that the fourth mortgage was not compensation for petitioner's indemnity losses.

Turning to the sections of the Code argued by the parties, we think it best to proceed section by section.

Section 162. Section 162(a) allows a deduction for all the ordinary and necessary expenses paid or incurred in carrying on any trade or business. For this section to be applicable to these facts the petitioner must show, among other things, that he was in a business--herein the real estate development business--to which the payments might "proximately" relate, that the payments were not Welch v. Helvering[12]-type capital pay-

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12 Welch v. Helvering, 290 U.S. 111 (1933).

ments made to purchase a good name, and that he did not stand as a creditor in relation to his principal, CO, after making payment. Although respondent attempts to characterize petitioner's business as that of a corporate executive and points to testimony to the effect that petitioner did not engage in any business on an individual basis so long as he was a member of HIN partnership, the partnership's business and hence, in this case, the petitioner's business was real estate development--from acquisition of land, to construction of improvements, to management of the property. Since he was in the real estate development business before undertaking the indemnity liability and remained in that business thereafter, the disputed amounts cannot be said to be capital expenditures to acquire goodwill. Compare Welch v. Helvering 290 U.S. 111 (1933); Falstaff Beer, Inc. v. Commissioner, 322 F.2d 744 (C.A. 5, 1963); Carl Reimers Co., Inc. v. Commissioner, 221 F.2d 66 (C.A. 2, 1954), with Samuel R. Milbank, 51 T.C. 805 (1969); L. Heller & Son, Inc., 12 T.C. 1109 (1949); Scruggs-Vandervoort-Barney, Inc., 7 T.C. 779 (1946); Edward J. Miller, 37 B.T.A. 830 (1938). The question which remains is whether upon payment to the bonding company in fulfillment of the indemnity agreement, petitioner became entitled to reimbursement from CO or, restated, whether the Putnam case and section 166 apply. The answer would ordinarily lie in State statutory or case law. Santa Anita Consolidated, Inc. 50 T.C. 536, 559-560 (1968). See also Putnam v. Commissioner, 352 U.S. 82 (1956); Bert W. Martin, 52 T.C. 140, 143 (1969), affirming per curiam 424 F.2d 1368 (C.A. 9, 1970). In this case, however, the parties have not cited, and we have not discovered, any dispositive Arizona law. Nevertheless, upon

consideration of the general case law, treatises, and restatements, we conclude that the correct answer is that the petitioner was actually both an indemnitor and a guarantor; that he did acquire a "remedy over" against CO, his and the bonding company's principal, and that this "remedy over" represents a debt falling within the provisions of section 166. See United States v. Hoffman, 423 F.2d 1217 (C.A. 9, 1970), for the proposition that an indemnitor in a four-party indemnity situation is to be treated the same as a guarantor. See generally, United States v. Generes, 405 U.S. 93 (1972); Reid v. Pauly, 121 Fed. 652 (C.C.A. 9, 1903).

A guarantor is one who promises either than another will perform his duty, or that, if another does not perform his duty, he will, non-performance by the other being a condition precedent to the guarantor's duty to pay. In the broader sense of the word "surety," a guarantor is also a surety; and, for the purposes of this discussion, an indorser is like a guarantor. An indemnitor is one who promises to hold another harmless from loss in respect to an obligation to a third person. "The great difference between the two [a guarantor and indemnitor] lies in the character of the promise. In * * *[guaranty] the promise runs to an obligee * * *, present or prospective. In indemnity the promise runs to an obligor * * *, present or prospective." Simpson, Handbook on the Lw of Suretyship 28 (1950). Whether a party is a guarantor or an indemnitor or both depends upon an analysis of the legal character of the actors and their obligations, not the terminology used. In the four-party indemnity situation, there is, for example, a principal-contractor, a creditor-obligee, a surety (or guarantor)-

bonding company, and an indemnitor-shareholder. The principal owes the creditor-obligee money or, more likely, some type of performance. The surety (or guarantor) promises the creditor-obligee that he will pay or perform if the principal does not. Clearly, in relation to the creditor-obligee, the surety (or guarantor) is an obligor. As a guarantor, however, he is entitled as a matter of law to be reimbursed by his principal; in this respect, he is also an obligee. The indemnitor promises the surety (or guarantor) that he will secure him against any loss on his obligation to the creditor-obligee. In this light the indemnitor is a true indemnitor since his promisee, the surety (or guarantor), is an obligor. But his promise is also an obligee, vis-a-vis the principal; and, in this other light, the indemnitor is also a guarantor, with all the rights and privileges of a guarantor. For instance, the so-called indemnitor in the four-party indemnity situation is entitled to subrogation to the rights of the surety (or guarantor) against the principal, i.e., any rights of the creditor-obligee against the principal acquired through subrogation and any right to reimbursement. "Much of the difficulty and confusion that exists in the cases in distinguishing between the contract of indemnity and the contract of suretyship [or guaranty] lies in the common failure to recognize the fact that the former is always accompanied by the latter whenever the four-party indemnity situation is involved." Simpson, supra at 30; Restatement of Security, §96. Thus, petitioner, the indemnitor in the above illustration, was as much a guarantor as an indemnitor. It is now well established that a guarantor, upon payment, stands in a creditor-debtor relationship with his principal. In this particular case the petitioner was sub-

rogated to the rights of the bonding company against the corporation, rights which the bonding company acquired through subrogation from the creditors for whose benefit the bonds were executed. It is equally well established that given such a creditor-debtor relationship, the guarantor, here the petitioner, must look to the bad debt provisions of section 166 for the deduction of related losses. And there is no doubt that the debt arising out of a guarantee that has been performed is a debt within the meaning of that term as used in section 166. Putnam v. Commissioner, supra.[13] See also Robert E. Gillespie, 54 T.C. 1025, 1031 (1970), and the cases cited therein.

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13 The deduction for bad debts first appeared in the Act of March 2, 1867, as an amendment to the Act of March 3, 1865, ch. 78, 13 Stat. 471, 479, which in turn amended sec. 117 of the Act of June 30, 1864, ch. 173, 13 Stat. 223, 281. ("* * * and in addition to one thousand dollars exempt from income tax, as hereinbefore provided, * * * debts ascertained to be worthless * * *.") In the Revenue Act of 1918, the deduction appeared in sec. 214(a)(7): "Debts ascertained to be worthless and charged off within the taxable year * * *." Revenue Act of 1918, ch. 18, 40 Stat. 1057, 1067. In connection with the 1918 provision, the following floor discussion took place:

> Mr. Graham of Illinois. How about losses caused by indorsements on accommodation paper? That is, where one signs as security for another and makes a loss in that way, does the bill take care of that, so that such a loss can be deducted?

In United States v. Hoffman, supra, the taxpayers, owners of an electric contracting corporation, had indemnified the bonding company which wrote bonds for the corporation and had had to make good. They claimed tax refunds for the amounts lost on the ground that these were losses deductible under section 165(c)(2). The district court held for the taxpayers, stating (266 F.Supp. 884, 886):

> Putnam is not in point. Unlike Putnam, the Hoffmans were indemnitors. An indemnitor has a primary obligation to the creditor and he is not subrogated to the creditors' rights. See: Howell v. Commissioner of Internal Revenue, 8 Cir. 1934, 69 F.2d 447.

The Court of Appeals for the Ninth Circuit reversed, relying upon Stratmore v. United States, 420 F.2d 461 (C.A. 3, 1970), a case involving guarantors. "That the Stratmores were guarantors and the Hoffmans were indemnitors is not a persuasive distinction between the two cases." United States v. Hoffman, supra at 1218. The principal of Putnam was applied. Thus the Hoffman case treats indemnitors in a four-party situation like guarantors.

By far the most in-depth judicial discussion of the problem appears in Chief

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> Mr. Kitchin. If he charges it off and does not hold the other man responsible for it, it can be deducted.

56 Cong. Rec., appendix p. 678. The remaining history of the deduction up to and including sec. 23(k) of the I.R.C. of 1939, is traced in footnote 9 of Putnam v. Commissioner, supra at 85.

Judge Andrews' opinion in Jones v. Bacon, 40 N.E. 216 (Ct. App. N.Y., 1895), affirming 25 N.Y. Supp. 212 (1893). In that case the indemnitor promised to hold the plaintiff harmless if he, the plaintiff, would guarantee the debt of the principal to a bank. Upon the princpal's default the plaintiff paid the required amount to the bank, released the principal, who was insolvent, and sued the indemnitor on the indemnity agreement. The indemnitor defended on the ground that the release defeated the plaintiff's right of action. The court so held, reasoning that but for the release, the indemnitor would have been subrogated to the rights of the indemnitee against his principal. The court said (40 N.E. 216):

> The indemnitor of the plaintiff, on restoring to him this sum in performance of the contract of indemnity, would be entitled to be substituted to the claim of the plaintiff against Kingsbury [the principal]. This stands upon the most obvious principles of natural justice. * * * There was no privity of contract between the plaintiff [the indemnitee-guarantor] and Kingsbury. On paying the plaintiff what he had been compelled to pay for Kingsbury, pursuant to the contract of indemnity, the indemnitor would stand as the equitable assignee of the plaintiff of the obligation of Kingsbury to him.

See also Aetna Casualty Co. v. Phoenix Co., 285 U.S. 209, 214 (1932).[14]

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[14] Because of our choice as to the disposition of this case, we need not consider

Since it is our view that a debtor-creditor relationship did arise, section 162 cannot apply. E.g., Oddee Smith, 55 T.C. 260, 267 (1970), remanded on another issue, ___F.2d ___(C.A. 5, 1972); Josef C. Patchen, 27 T.C. 592, 600 (1956), affirmed in part and reversed in part on another issue, 258 F.2d 544 (C.A. 5, 1958). See and compare Samuel R. Milbank, supra, where no debtor-creditor relationship arose.

Section 165. Section 165(c) provides a deduction, in the case of individuals, for losses incurred in a trade or business or losses incurred in a transaction entered into for profit. This provision cannot be relied upon where section 166 is applicable. Spring City Foundry Co. v. Commissioner, 292 U.S. 182 (1934) (involving section 234(a)(4) and (5) of the Revenue Act of 1918, 40 Stat. 1077, predecessors of sections 166 and 165);

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two other grounds for finding a creditor-debtor relationship between petitioner and CO. (1) It is argued that as a general rule indemnitors should be treated as guarantors for sec. 166 purposes. Compare United States v. Hoffman, supra, and Jones v. Bacon, supra, with Howell v. Commissioner, 69 F.2d 447 (C.A. 8, 1934). (2) It is argued that as a co-indemnitor who was not directly benefited by the indemnification, the petitioner was entitled to 100 percent contribution from CO, the co-indemnitor who was directly benefited, and that this represents a sec. 166 debt. But see Security Ins. Co. v. Johns-Manville Sales Corp., 442 P.2d 555 (Ct. of App. of Ariz. 1968) for an example of how difficult it is to weigh the equities in such a case.

Putnam v. Commissioner, supra (decided under the Internal Revenue Code of 1939); Inman-Poulsen Lumber Co. v. Commissioner, 219 F.2d 159 (C.A. 9, 1955) (also decided under the Internal Revenue Code of 1939).

Section 212. Section 212 allows as a deduction all the ordinary and necessary expenses paid or incurred for the production or collection of income and for the management, conservation, or maintenance of property held for the production of income. Petitioner maintains that real estate development was his source for the production of income and that that source would have been impaired if he had not agreed to enter into the indemnity agreement with the bonding company. In addition, he says that his actions helped preserve CO, the property from which he derived his income. It is unnecessary to analyze these arguments in light of the facts since petitioner, whether he knew it or not, had a fixed, readily assertable right to payment by CO. This one fact alone makes section 212 inapplicable. Estate of Elmer B. Boyd, 28 T.C. 564, 566 (1957). Cf. Electric Tachometer Corp., 37 T.C. 158 (1961).

Section 166. Section 166(a) provides that there shall be allowed as a deduction any debt which becomes wholly worthless within the taxable year. Subsection (d) provides, with respect to nonbusiness debts, that any loss resulting therefrom shall be treated as a short-term capital loss. Paragraph 2 of subsection (d) states that "the term 'nonbusiness debt' means a debt other than - (A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or (B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade

or business."

As we have previously indicated, it is our opinion that this is basically a section 166 case. We might add that we do not think that petitioner should be viewed as a mere volunteer, nor that his right to payment by CO should be characterized as simply an unadjudicated claim. See and compare Phillip H. Schaff, 46 B.T.A. 640 (1942).

It is unnecessary for us to decide the question of whether the losses of the petitioner were business or nonbusiness bad debt losses because we find that the debts were not worthless in the year claimed. It appears from the testimony not only that some amounts--less than one-half the total amount--have been repaid, but also that CO was financially able to repay additional amounts. CO never went bankrupt. Indeed, in each of the three years before us, CO's net worth exceeded $600,000. The fact that there were operating losses does not contradict this conclusion. Pachella's Estate v. Commissioner, 310 F.2d 815 (C.A. 3, 1962), affirming 37 T.C. 347 (1961). See Higgenbotham-Bailey-Logan Co., 8 B.T.A. 566 (1927).

To reflect the conclusions reached herein,

Decision will be entered under Rule 50.

UNITED STATES TAX COURT

M. SETH HORNE and MAURINE D. HORNE,	)	
Petitioners,	)	Docket No. 2645-70
v.	)	
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent.	)	

DECISION

Pursuant to the opinion of the Court filed November 27, 1972, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED and DECIDED: That there are deficiences in income taxes due from the petitioners for the taxable years 1966, 1967 and 1968 in the amounts of $56,280.00, $23,378.00 and $66,078.00, respectively.

/s/ Howard A. Dawson, Jr.
Judge

Entered: February 12, 1973

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

M. SETH HORNE and MAURINE D. HORNE, Petitioner,	)	No. 73-2349
vs.	)	OPINION
COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	

On Appeal from a Decision of the United States Tax Court

Before: CHAMBERS, Circuit Judge, BALDWIN,* Judge of the Court of Customs and Patent Appeals, and WALLACE, Circuit Judge.

CHAMBERS, Circuit Judge:

The issue in this case is whether payments of approximately $300,000 made by taxpayer M. Seth Horne as indemnitor in connection with obligations of corporations in which he owned a substantial interest are deductible as ordinary losses. Horne was the principal partner in a real estate development firm which owned all the outstanding shares of James Stewart and Co., Inc. (COINC). COINC had two wholly-owned subsidiaries, James Steward Corporation

*The Honorable Phillip B. Baldwin, Judge of the United States Court of Customs and Patent Appeals, sitting by designation.

(CORP) and James Stewart Company (CO). All three corporations were engaged in construction and general contracting work in which it was necessary for them to post performance bonds as a condition of obtaining the contract. The bonds were obtained from New Amsterdam Casualty Company (NA). Each corporation agreed to indemnify NA against losses it incurred as surety for the other two.

In 1960, all three corporations were in financial trouble and NA was informed that CO would not be able to complete its existing contracts and that COINC and CORP lacked sufficient funds to perform their obligations as indemnitors. NA estimated its liability exposure at this time to be one million to one and a half million dollars, and requested that Horne and his partners agree to assume personal indemnity obligations. Horne was willing but his partners refused. Following this disagreement, the partnership was dissolved and the corporations were reorganized. The assets of COINC and CORP were transferred to CO; Horne received all the stock of CO in exchange for his shares in COINC; and COINC and CORP became inactive.

Contemporaneously with the reorganization, Horne agreed with NA that he and CO would be jointly and severally liable for any amounts expended by NA in connection with eight contracts previously entered into by CO, any liability incurred by CO under the earlier cross-indemnity agreements, and interest. NA agreed to release COINC and CORP from their cross-indemnity agreements, except as to specified contracts.

During 1966 through 1968, Horne paid NA approximately $600,000 under the in-

demnity agreement and recouped less than half of this amount from CO. At all times during this period, CO and its successor corporation had a net worth of over $600,000; by 1971 its net worth was about $5 million. On his income tax returns for 1966, 1967, and 1968, Horne treated one-half of his indemnity payments as ordinary losses. (The other half was teated as loans to CO.) In the tax court, Horne argued these losses were fully deductible from ordinary income under Int. Rev. Code of 1954, § 165 (c) as losses incurred in a trade or business or under sections 162 or 212 as ordinary and necessary expenses incurred in a trade or business or for the production of income. The Commissioner argued they should be deductible only as non-business bad debts under Int. Rev. Code of 1954, § 166(d). As such, they would be treated as short term capital losses and be deductible only in the taxable year in which they became worthless. Id. § 166(d)(1)(B).[1]/ The tax court accepted the Commissioner's view that bad debt treatment was appropriate and concluded that inasmuch as CO was financially able to repay Horne during the relevant years, the debts were not worthless and no deduction was permitted. M. Seth Horne, 59 T.C. 319 (1972). We affirm.

The Supreme Court, interpreting provisions of the 1939 Internal Revenue Code similar to section 166, has held that payments made by a shareholder in discharge of his obligation as guarantor of notes issued by his corporation were deductible only as bad debts. Putnam v. Commissioner, 352 U.S. 82 (1956). In United States v. Hoffman, 423 F.2d 1217 (9th Cir. 1970), we held that section 166 covers payments by an indemnitor as well. Horne seeks to distinguish these authorities by arguing

that the essense of the Putnam rule is that the taxpayer as guarantor acquired upon payment a claim against the corporation by subrogation. This claim was the "debt" that became worthless. Arguing that under the law of Arizona, where the indemnity agreements presumably were entered into, an indemnitor has no right to subrogation, at least where as here he is not a party to the original transaction between principal debtor and surety, Horne contends that without a remedy over against the corporation there is no "debt" to render section 166 applicable.

We think this argument misunderstands the operation of the statutory scheme. The loss covered by section 166(d) is "the loss resulting from [the worthlessness of a nonbusiness debt]" (emphasis added); this language, we believe, includes not only any loss sustained by a third party, whether acting as surety, guarantor, or indemnitor. Thus, the section is triggered by the worthlessness of the principal debt, and no independent debt between principal debtor and the third party, created by subrogation, is necessary.

As Horne points out, the Supreme Court in Putnam did state that the guarantor would have a remedy over against the maker of the notes, but we do not read this discussion as essential to its opinion.[2/] The purpose of section 166(d), as seen by the Court in Putnam,[3/] was to assure capital loss treatment to all nonbusiness investments, whether in the form of loans or of stock. Under Horne's view, the taxpayer may circumvent this policy, as well as the general requirement of section 166 that no deduction is to be allowed unless the principal debt is in

fact worthless, by skillfully drafting his undertaking as a promise to indemnify or any other form of obligation which, under the law of the particular state involved, gives him no remedy over against the principal debtor. Since, ordinarily, no payment of indemnity will be required unless the borrower is unable to pay the principal debt, the availability of such a remedy against the borrower is likely to be a matter of academic interest only. See Stratmore v. United States, 420 F.2d 461, 465 (3d Cir. 1970), cert. denied, 398 U.S. 951 (1970). No reason is advanced why Congress would have intended tax consequences to flow from the mere existence of a right of such doubtful economic significance.

Our conclusion that payments under obligations of guaranty and indemnity are to be treated the same is corroborated by section 166(f).[4] That section, inapplicable in this case because it is limited to noncorporate obligations, provides that any payments by a taxpayer in discharge of his obligation as "guarantor, endorser, or indemnitor," where the proceeds of the original obligations were used in borrower's trade or business, are to be treated as a debt becoming worthless within the taxable year in which the payment is made. No distinction on the basis of the existence of a remedy over against the borrower is made.[5]

Because of our conclusion that section 166 covers the indemnity payments involved here, deductibility under the sections asserted by Horne is precluded.[6] Thus, Horne's payments are deductible only if the underlying obligations of his corporation were worthless at the time the payments

were made. Cf. Int. Rev. Code of 1954, § 166(f). In view of the tax court's determination that CO possessed the resources to reimburse Horne during the period, we must conclude the obligations were not worthless and therefore no deduction is permitted.

The decision of the tax court is affirmed.

Footnote 1

1. Int. Rev. Code of 1954, § 166(d) provides:

(d) Nonbusiness debts. -

(1) General rules. - In the case of a taxpayer other than a corporation -

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the date of exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) Nonbusiness debt defined. - For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than -

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

Footnote 2

Cf. Bert M. Martin, 52 T.C. 140, 144-47 (1969), aff'd, 424 F.2d 1368 (9th Cir. 1970). But see id. at 147 (concurring opinion).

Footnote 3

352 U.S. at 91-93. But see B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 4.09, at 4-35 n. 72 (3d ed. 1971).

Footnote 4

Int. Rev. Code of 1954, § 166 (f), provides:

> (f) Guarantor of certain noncorporate obligations. - A payment by the taxpayer (other than a corporation) in discharge of part or all of his obligation as a guarantor, endorser, or indemnitor of a noncorporate obligation the proceeds of which were used in the trade or business of the borrower shall be treated as a debt becoming worthless within such taxable year for purposes of this section (except that subsection (d) shall not apply), but only if the obligation of the borrower to the person to whom such payment was made was worthless (without regard to such guaranty, endorsement, or indemnity) at the time of such payment.

Footnote 5

In discussing section 166(f), the Senate Committee Report on the 1954 Code states:

> The term "guarantor, endorser, or indemnitor" includes not only those persons having collateral obligations as guarantors or endorsers but also those persons having direct obligations as indemnitors. S. Rep. No. 166, 83d Cong., 2d Sess. 200 (1954).

Footnote 6

Putnam v. Commissioner, 352 U.S. 82, 87 (1956); Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 189 (1934).

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

M. SETH HORNE and MAURINE D. HORNE, Petitioner-Appellant,	)	No. 73-2349
vs.	)	AMENDED ORDER DENYING PETITION FOR REHEARING
COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee.	)	

Before: CHAMBERS and WALLACE, Circuit Judges, and BALDWIN, Associate Judge, United States Court of Customs and Patent Appeals.

Appellant's petition for rehearing is denied. Our disposition in this case simply enforces the policy embodied in § 166 (d) as developed in Putnam v. Comm'r, 352 U.S. 82, 92-93 (1956); United States v. Hoffman, 423 F.2d 1217 (8th Cir. 1970); Martin v. Comm'r, 424 F.2d 1368 (9th Cir. 1970), aff'd 52 T.X. 140, 144-47 (1969); Stratmore v. United States, 420 F.2d 461, 464-65 (3rd Cir. 1970).

Filed: March 27, 1978

Supreme Court, U. S.
FILED
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MICHAEL RODAK, JR., CLERK

No. 77-1824

In the Supreme Court of the United States

OCTOBER TERM, 1978

M. SETH HORNE AND MAURINE D. HORNE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. App. 1-40) are reported at 59 T.C. 319. The opinion of the court of appeals (Pet. App. 42-49) is reported at 523 F. 2d 1363.

JURISDICTION

The judgment of the court of appeals was entered on September 30, 1975, and its order denying rehearing was entered on March 27, 1978 (Pet. App. 50). The petition for a writ of certiorari was filed on June 23, 1978. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether payments petitioner made in satisfaction of his obligation as indemnitor of the debts of a corporation, of which he was president and majority shareholder, gave rise to debts that had not become wholly worthless so as to be nondeductible under Section 166(d) of the Internal Revenue Code of 1954.

STATUTES INVOLVED

The pertinent provisions of Sections 165 and 166 of the Internal Revenue Code of 1954 (26 U.S.C.) are set forth at Pet. 3-4.

STATEMENT

Petitioner[1] was the principal partner in a real estate development firm which owned all the outstanding shares of James Stewart and Co., Inc. (COINC). COINC had two wholly-owned subsidiaries, James Stewart Company (CO) and James Stewart Corporation (CORP). All three corporations were engaged in construction and general contracting work. In the conduct of their business they were required to furnish performance bonds and New Amsterdam Casualty Company, a bonding company, issued bonds to the three companies. Each corporation agreed to cross-indemnify New Amsterdam against any losses New Amsterdam might incur as surety for the other two corporations (Pet. App. 3-9, 42-43).

In 1960, New Amsterdam was informed that CO would not be able to complete its existing construction contracts and that COINC and CORP lacked sufficient funds to

[1]"Petitioner" refers to M. Seth Horne. Maurine D. Horne is a party because she filed a joint return with her husband for the years in issue.

perform their obligations as indemnitors under the cross-indemnity agreements. New Amsterdam thereupon requested that petitioner and his partners assume personal indemnity obligations for any loss incurred on the three corporations' bonds. Although the other partners refused to assume personal liability, petitioner acceded to prevent the loss of his investment in COINC and damage to his credit reputation. The partnership was dissolved and the corporations were reorganized, with the assets of COINC and CORP transferred to CO. Petitioner received all of the stock of CO in exchange for his shares of COINC (Pet. App. 9-10, 43).

Contemporaneously with the reorganization of the three corporations on January 20, 1961, petitioner entered into an indemnity agreement with New Amsterdam and CO, pursuant to which he became jointly and severally liable with CO for any losses incurred by New Amsterdam as surety for CO. Subsequently, New Amsterdam made payments on behalf of CO, and petitioner, pursuant to the indemnity agreement, paid New Amsterdam $237,434 in 1966, $121,749 in 1967, and $238,246 in 1968. CO treated half of the amounts paid by petitioner to the bonding company during 1966 through 1968 as paid-in capital, and the remaining half as an account payable to petitioner (Pet. App. 20, 44). CO subsequently repaid petitioner part of the amount treated by him as loans to CO (Pet. App. 43-44; Tr. 177).[2]

On his federal income tax returns for 1966, 1967, and 1968, petitioner deducted one-half of the amounts he paid to New Amsterdam as ordinary losses under Section 165. The amounts deducted by petitioner as losses were the

[2]"Tr." refers to the trial transcript.

portions (one-half of each payment) treated as paid-in capital (Pet. App. 20). During these same years, CO and its successor corporation had a net worth (excess of assets over liabilities) of more than $600,000; by 1971, its net worth was approximately $5 million (Pet. App. 24, 43-44).

On audit, the Commissioner of Internal Revenue disallowed the claimed deductions. The Commissioner determined that the payments represented additional contributions to the capital of the corporation, or, alternatively, that the sums paid gave rise to nonbusiness debts under Section 166(d) that had not become worthless during the years in issue (Pet. App. 24-25). The Tax Court held that the payments were debts but that they were not worthless and therefore not deductible because CO was financially able to repay petitioner during the years at issue (Pet. App. 39-40).

The court of appeals affirmed (Pet. App. 42-44). It stated: "In view of the tax court's determination that CO possessed the resources to reimburse [petitioner] during the period, we must conclude the obligations were not worthless and therefore no deduction is permitted" (Pet. App. 47).[3]

ARGUMENT

1. The decision below correctly held that petitioner's payments to the surety were not deductible. Petitioner seeks to deduct one-half of the payments as ordinary

[3]Both courts rejected petitioner's alternative arguments that the amounts paid to the surety were fully deductible as ordinary and necessary business expenses under Section 162 or as expenses incurred in the production of income under Section 212 (Pet. App. 31-32, 39, 46). Petitioner no longer relies upon Section 212 in support of his claimed deduction.

losses under Section 165(c)(2) or as ordinary and necessary business expenses under Section 162. But petitioner and his corporation treated the amounts in question as paid-in capital contributions to the corporation (Pet. App. 20).[4] As such, they were not deductible, in accordance with the rule set forth in Section 263. A shareholder's contribution of capital to his corporation is not deductible but increases the basis of his stock. While a capital contribution may result in a subsequent loss upon disposition, corporate liquidation or worthlessness of the stock, none of these occurrences took place here. To the contrary, the record establishes that at all times during the years in question (1966-1968), petitioner's corporation had a net worth of more than $600,000, and by 1971, its net worth was approximately $5 million (Pet. App. 24, 44). Accordingly, the corporation was a thriving going concern. Thus, even on the assumption that the payments were not contributions to capital, petitioner is not entitled to an ordinary deduction under Section 165 because he sustained no loss during the tax years in issue. See Treasury Regulations, Section 1.165-1(a) and (b) Cf. *Burns* v. *Commissioner*, 31 F. 2d 399, 400-401 (C.A. 5); *Perlman* v. *Commissioner*, 252 F. 2d 890 (C.A. 2); *Bavinger* v. *Commissioner*, 22 B.T.A 1239.[5]

[4]The remaining half of the amounts paid by petitioner to the surety was treated as an account payable to him, at least part of which the corporation subsequently repaid (Pet. App. 20, 44; Tr. 177).

[5]Although the Tax Court rejected (Pet. App. 28-29) the government's argument that the payments were part of petitioner's basis in the CO stock, it did so on the ground that petitioner's indemnification obligation was not part of the consideration that he paid for the acquisition of the stock from his two former partners. In this respect, the Tax Court overlooked (Pet. App. 28-29 n. 11) the government's additional contention that the payments represented a subsequent contribution by petitioner to the capital of the corporation.

2. Alternatively, even if petitioner's payments are viewed as a loan to the corporation,[6] rather than as capital contributions, the courts below correctly concluded that petitioner was not entitled to a bad debt deduction under Section 166 because there was no evidence that the debts became worthless during the years in issue, a factual finding no longer challenged by petitioner. Since both courts found (Pet. App. 40, 47) that the corporation had the resources to reimburse petitioner at all times during the years in issue, there is no basis for a bad debt deduction.

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[6]The courts below treated the payments as deductible, if at all, as a nonbusiness bad debt under Section 166, rather than Section 165, on the basis of *Putnam* v. *Commissioner*, 352 U.S. 82. There, the Court held that payments made by a taxpayer-shareholder as guarantor of loans to his corporation were deductible only as nonbusiness bad debts under Section 166(d) and could not be deducted under Section 165(c)(2) as losses incurred in a transaction entered into for profit.

Petitioner asserts (Pet. 15-16) that the rule of *Putnam* does not apply because as indemnitor rather than a guarantor, he was not subrogated to the rights of the lender against the debtor-corporation. Although *Putnam* turned in part upon the taxpayer's right of subrogation, the Court in *Putnam* also emphasized that in order to give Section 166(d) its intended effect, it was essential that all taxpayers who incur losses in providing financing for their corporations should receive the same tax treatment, regardless of the particular method of financing used. On the basis of this rationale, the court below concluded, in accordance with *Martin* v. *Commissioner*, 52 T.C. 140, 144-146, affirmed *per curiam*, 424 F. 2d 1368 (C.A. 9), certiorari denied, 400 U.S. 902, and *Stratmore* v. *United States*, 420 F. 2d 461, 464-465 (C.A. 3), certiorari denied, 398 U.S. 951, that the statutory scheme mandates a common tax treatment for all losses suffered by a shareholder in providing his corporation with financial assistance, and that different tax results should not turn on the technical right of subrogation. See also *United States* v. *Hoffman*, 423 F. 2d 1217 (C.A. 9); *United States* v. *Generes*, 405 U.S. 93. (And see H. Rep. No 94-658, 94th Cong., 1st Sess., p. 177 (1975), describing Congress' understanding of the present law, prior to the repeal of Section 166(f) of the Code, as follows: "* * * in the case of a

3. *Stahl* v. *United States*, 441 F. 2d 999 (C.A. D.C.), and *Lutz* v. *Commissioner*, 282 F. 2d 614 (C.A. 5), upon which petitioner relies (Pet. 12, 16), are not to the contrary. In *Stahl*, the taxpayer loaned securities to a securities firm so that the firm could satisfy certain SEC requirements. When the securities were subsequently sold by the firm prior to its bankruptcy, the taxpayer suffered a loss and the only question was whether it was fully deductible under Section 165(c), or deductible only as a nonbusiness bad debt under Section 166. The court held that it was deductible under Section 165, on the ground that the transaction constituted a bailment rather than a "debt." Unlike petitioner, the taxpayer in *Stahl* unquestionably sustained a loss during the year in issue. Moreover, the court in *Stahl* carefully distinguished *Putnam* (and its subsequent application in *Stratmore* v. *United States*, *supra*, and *United States* v. *Hoffman*, *supra*) on the ground that the taxpayer in *Stahl* was not a shareholder in the corporation to which she gave her securities and, therefore, the transaction did not represent "financing provided to a corporation by a taxpayer-stockholder to protect his pre-existing investment" (441 F. 2d at 1003).

Lutz is likewise distinguishable. There, the court upheld the taxpayer's claim to a business expense deduction

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guarantor of a corporation obligation [a term which includes indemnitors for purposes of Section 166(f)], any payment under the guaranty agreement must be deducted (if at all) as a nonbusiness bad debt, regardless of whether there is any right of subrogation, unless the guaranty was made pursuant to the taxpayer's trade or business.") Since the post-*Putnam* cases have not regarded the state law of subrogation as material for federal tax purposes (see also *Siple* v. *Commissioner*, 54 T.C. 1), and petitioner sustained no loss, there is no basis for petitioner's assertion (Pet. 11-14) that the decision below conflicts with *Howell* v. *Commissioner*, 69 F. 2d 447 (C.A. 8), a case decided 22 years prior to this Court's decision in *Putnam*.

under Section 162 for his voluntary payment of debts of certain controlled farm corporations which he had paid to protect his individual business as an agriculture produce broker. Here, on the other hand, the record shows (Pet. App. 4, 19) that petitioner did not engage in any business activities on an individual basis separate from that of the partnership or corporation. Rather, the advances were made primarily to protect his investment in the corporation. *Whipple* v. *Commissioner,* 373 U.S. 193; *United States* v. *Generes,* 405 U.S. 93.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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